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SUBJECT: Scenesetter for February 15-18, 2010 Visit of David Goldwyn to Mexico City

¶1. (SBU) Summary. Your visit comes at a time when we have a unique opportunity to deepen our bilateral energy relationship with Mexico, our third largest source of oil imports. As the largest source of export earnings and contributor of over one third of budget revenues, the oil sector is a critical component of the Mexican economy. Due to the decline of Mexico's largest oil field and underinvestment in new exploration and exploitation, Mexican crude oil production is declining rapidly and the country could become a net oil importer within five years. The Calderon Administration broke a taboo early in its term by addressing the need for energy reform and engaging the public in a discussion of necessary changes. However, the modest October 2008 reform package that Mexico's Congress passed does not address the constitutional prohibition on private investment in the oil sector. For Mexico, declining oil income will require the GOM to search for alternative sources of revenue - perhaps through increased tax collection. For the United States, declining imports from Mexico have implications for North America energy security - especially in the short and medium term. The Calderon Administration's August 2008 proposal to negotiate a US-Mexico agreement on trans-boundary reservoirs demonstrates a new willingness by Mexico to engage bilaterally on oil and gas topics. Our preliminary discussions on the Mexican proposal have opened the door to other opportunities for collaboration. End Summary.

Political Context

¶2. (SBU) Present Calderon enters the last three years of his six-year term facing a complicated political and economic environment. His PAN party emerged seriously weakened from a dramatic 2009 mid-term election in which the opposition (PRI) gained control of the Mexican Congress. His popularity numbers have dropped 10-points since the beginning of last year, yet they still hover solidly over 50 percent. He is by no means a lame duck. Still, the opposition PRI party is in the ascendancy, cautiously managing its illusory unity in an effort to dominate the ten gubernatorial contests that are up in the coming year, and to avoid any missteps that could jeopardize its front-runner status in the run-up to the 2012 presidential elections. In addition, the public's deepening economic worries have begun to counterbalance their concern about security.

Economic Context

¶3. (SBU) Following the 2009 electoral setback, Calderon made promoting jobs and eradicating poverty his top two priorities for 2010, sharing the agenda with security issues that have become

acutely sensitive in the past weeks due to the persisting violence in Ciudad Juarez. It is important that Calderon succeed in making real progress on the economy and security in the last three years of his term. The economic and security agendas are time-sensitive and volatile, and the more momentum that can be achieved now, the greater the prospect for continuity into a new administration. However, the complexities of pushing viable economic reforms through an opposition Congress complicate advancing such an agenda. If Calderon is unable to strengthen Mexico's competitiveness in order to promote jobs and eradicate poverty, the United States will also feel the impact through immigration pressures and greater volatility in high-violence cities that have been the battleground for narco-traffickers. A stable and growing Mexico is in both our security and economic interests.

Mexico's Energy Challenge

¶4. (SBU) The oil sector is a crucial component of Mexico's economy and is the largest source of export earnings for the country, accounting for 10 percent of all export earnings. However, Mexico's oil production has declined rapidly from a peak of 3.4 million barrels per day in 2004 to a projected 2.5 million barrels per day in 2010. Despite some optimistic GOM forecasts, there are no realistic options for reversing this decline in the short to medium term. Mexico has relied heavily on the Cantarell oil field, one of the largest in the world. Despite nitrogen injection and other enhanced oil recovery techniques, the Cantarell field has entered a stage of long-term decline with production falling by more than 70% from its peak of over 2 million barrels a day in 2004 to less than 650,000 barrels per day in 2009.

¶5. (SBU) The Mexican government's reliance on oil revenue to finance over one third of the federal budget has deprived Mexico's state owned oil company, Pemex, of much needed capital for exploration, production, and infrastructure projects. As a result of decades of underinvestment, Pemex today finds itself without alternative oil fields which could compensate for Cantarell's decline. Pemex accelerated the development of the giant Chicontepec oil basin in 2009, investing $2 billion with the goal of increasing production from 29,000 to 90,000 barrels in 2009. With 750 new wells drilled over the past year, overall production remains stagnant and production per well has fallen dramatically. Although the Chicontepec fields are estimated to contain almost 9 billion barrels of reserves, Chicontepec is a complex reservoir which involves technical challenges and significant operational costs. Exploiting Chicontepec will require high-risk investments and the drilling of a large number of wells for relatively small returns. Many experts believe that even with substantial investments, Pemex will have a difficult time reaching its 600,000 barrel a day production goal by 2021. Other fields Mexico is currently exploiting include Ku Maloob Zaap, which has reached peak production levels; Crudo Ligero Marino and other smaller fields in the south which are largely enhanced oil recovery projects which will do little to reverse Mexico's production decline.

¶6. (SBU) Mexican officials acknowledge that the greatest opportunities for reversing declining production lie in the deep waters of the Gulf of Mexico, with Pemex estimating that 56 percent of prospective resources are in that area. To date, Pemex's deepwater results have been disappointing. The parastatal has contracted service companies to drill twelve deep water wells for a total investment of approximately $750 million, but none of these have proven commercially viable. Two new deepwater rigs will start working for Pemex in 2010, boosting exploration efforts. Some

energy experts opine that Pemex is under such pressure to reverse production declines that it has not conducted sufficient seismic analysis to begin these exploration efforts. Even if Mexico were to discover a significant oil field in the deep waters of the Gulf, these experts predict that it would take at least 7-10 years to move from discovery to production.

2008 Energy Reform

¶7. (SBU) The energy reform package approved by the Mexican Congress in late October 2008 was a significant political victory for the Calderon administration. The fact that the three principal political parties in Congress acknowledged the need to reform this sensitive sector - long a taboo subject on the Mexican political scene - was in itself historic. Substantively, the reform will give greater financial autonomy and more decision making power to Pemex. However, the Calderon Administration made a political decision not to tackle the sacrosanct Constitutional prohibition on private sector investment. As a result, the reform does not address the most pressing issue facing Pemex - declining production. To explore and develop Mexico's more costly, difficult but promising fields - especially deepwater - Pemex needs to diversify risk, attract private investment (possibly through joint ventures) and access the technological capabilities and expertise of the international oil companies. The reform allows only for performance-based contracts. Pemex and SENER, in consultation with the international oil companies and other interested parties, are developing the draft contracts now. We understand that a draft text will be sent to stakeholders February 15 for comments. Tenders will likely begin with projects in Chicontepec this spring. GOM officials claim that a constitutional challenge against the implementing regulations for the new contracts will not delay this process, but companies may be less inclined to bid given legal uncertainties.

¶8. (SBU) The energy reform will allow more flexibility on exploiting potential transboundary reserves. According to Mexican government officials, since not all the oil resources in a transboundary field belong to Mexico, the constitution would not prohibit PEMEX from entering into a joint venture with an IOC. The reform provides that transboundary reservoirs would be exploited in accordance with the provisions of a bilateral treaty that has been ratified by the Mexican Senate. The Chamber of Deputies, which would be more critical of such provisions, would not have jurisdiction. PEMEX added that their intention on exploiting potential U.S.-Mexico transboundary fields would be to collaborate closely with the companies and use the infrastructure on the U.S. side of the boundary as a way of making cooperation with IOCs more palatable.

Outlook for Future Reforms

¶8. (SBU) Energy experts and the private sector are in general agreement that declining production will eventually force Mexico to introduce energy reforms which will open the oil and gas sector to private investment. This could take some time, however, as the October 2008 reforms are still being implemented. Moreover, political pressures as Mexico approaches important gubernatorial elections in 2010, 2011 and a presidential election in 2012, make it difficult for the administration to move aggressively on this front in the short term future.

¶9. (SBU) Mexico officials remain extremely sensitive about any public - especially US - comments regarding energy reform and production. Quietly, Mexico is reaching out to other countries - especially those with state owned oil companies - for advice on implementation of the reforms. We should retain the USG's

long-standing policy of not commenting publicly on these issues while quietly offering to provide assistance in areas of interest to the GOM. Mexican officials have asked for USG assistance in recent months on select topics involving implementation of the October 2008 reforms. The GOM has expressed interest in learning more about the US Minerals Management Service, US gas flaring regulations, how US grants for energy research and development programs are organized, gas and oil leasing procedures and other topics. The Calderon Administration may also be interested in discussing how to address jointly the global shortage of petroleum engineers, geologists and other technical experts. You may want to emphasize our interest in working with Mexico on these topics.

Electricity

¶10. (U) Under Mexico's constitution, the generation, transmission, distribution and marketing of electric power is reserved for the federal government, specifically the Federal Commission of Electricity (CFE), with few exceptions. Since 1992, the government has encouraged private sector participation in the power sector in the following areas: independent power production (IPP) or private power generation facilities which sell production to CFE; self-supply; co-generation; small scale (less than 30 MW); export; and import for self supply. The total installed capacity in the country in 2008 was 51,000 MW, of which fourteen percent was cogeneration or self supply. Mexican power production comes from the following resources: 40 percent natural gas; 27 percent fuel oil; 22 percent hydro; 6 percent coal; 3 percent nuclear and 2 percent wind and geothermal.

¶11. (U) The government encourages IPPs to construct combined cycle gas fired power plants.

The key issues facing IPPs, however, include the lack of infrastructure to supply natural gas to power plants under development and the increasing cost and scarcity of natural gas in Mexico. As a result, liquefied natural gas (LNG) has become more important for Mexico as CFE develops its own long-term arrangements with LNG suppliers. There are two LNG terminals in operation in Mexico: Ensenada - Sempra; Altamira - Shell, Mitsui and Total; and one under construction in Manzanillo.

¶12. You can use this opportunity to ask the GOM about their long term natural gas production and supply plans. You may want to ask what plans Mexico has to improve its natural gas infrastructure,

especially along the Caribbean coast.

Renewable Energy

¶13. (SBU) Advancing bilateral cooperation on renewable energy, energy efficiency and the environmental agenda has been a top priority for both President Obama and President Calderon since their first meeting January 2009. This agenda was formalized when the Bilateral Clean Energy and Climate Change Framework was announced during President Obama's April 2009 visit to Mexico. On January 25-26 a senior level working group met in Washington to discuss pragmatic steps to advance this collaboration. The working group agreed to establish a bilateral task force which will work to create a renewable energy market between Baja California and California. The task force will consider standards, transmission capacity, regulatory issues and financing. This pilot project could be applied more broadly across the border, creating

significant opportunities for US companies to export green technology to Mexico. The January 25-26 meeting also helped advance cooperation on the Framework Convention on Climate Change 16th Conference of the Parties (COP-16) which Mexico is hosting in late 2010.

¶14. (SBU) You may wish to stress President Obama's personal commitment to advancing a joint agenda on climate change and renewable energy. You could stress the administration's commitment to use all available policy and financial tools, drawing on DOE, EPA, State, TDA, USAID, OPIC and EXIM to create a viable renewable energy market between the countries. This wider context will also help reinforce USTR's Trade Climate Initiative, which seeks to fast track tariff cuts for climate friendly technologies. Ambassador Kirk raised this point during his February 8-9, 2010 visit to Mexico.

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